

ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

IN THE MATTER OF THE COMMISSION'S ) CAUSE NO. 42779 S1  
INVESTIGATION OF THE CITY OF SOUTH BEND'S )  
RATE STRUCTURE FOR WATER SERVICE ) APPROVED:

AUG 13 2008

**BY THE COMMISSION:**

**David E. Ziegner, Commissioner**

**Loraine L. Seyfried, Administrative Law Judge**

On January 28, 2005, the City of South Bend, Indiana ("South Bend" or the "City") filed a Petition requesting authority to issue bonds, notes or other obligations and to increase its rates and charges for water service on an across-the-board basis. That proceeding was docketed as Cause No. 42779. An intervening party consisting of a class of former customers of Clay Utilities, Inc. ("Clay Customers") and the Indiana Office of Utility Consumer Counselor ("OUCC") filed testimony urging elimination of South Bend's rate differential for customers lying outside the City's corporate boundaries (the "Out-of-Town Differential") in that Cause. South Bend opposed this relief on the basis that the Out-of-Town Differential had been properly approved by the Indiana Utility Regulatory Commission ("Commission") and should not be eliminated absent sufficient evidence concerning the cost to serve the City's customers.

On February 8, 2006, the Commission issued an order in Cause No. 42779 (the "2006 Rate Order") authorizing South Bend to issue bonds and to increase its rates across-the-board. Subsequent to South Bend's filing of its revised tariff, the approved rate increase became effective on February 16, 2006.

In the 2006 Rate Order, we also found that the OUCC and Clay Customers had not submitted sufficient evidence in that proceeding to support elimination of the Out-of-Town Differential but did conclude that sufficient questions had been raised to justify further investigation. Consequently, based on South Bend's suggestion, we initiated this subdocket to investigate, through an examination of a cost-of-service study or studies for water service, and any other relevant evidence, whether the City's rate structure is appropriate. South Bend was required to submit a cost-of-service study within six months of the date of the 2006 Rate Order.

Clay Customers filed a Motion for Clarification of the 2006 Rate Order seeking clarification that South Bend's cost of service study must separately establish the cost of service to the Clay Customers and other customers residing outside the City. South Bend filed a Response opposing the clarification sought by Clay Customers on March 9, 2006 to which Clay Customers responded on March 20, 2006. The Presiding Officers issued a Docket Entry on March 30, 2006 concluding that no additional clarification of the 2006 Rate Order was necessary. The Docket Entry noted that there was a "reasonable expectation" South Bend

would conduct its cost of service study in accordance with the American Water Works Association ("AWWA") recommendations and that all other parties "will have the opportunity to respond to the City's cost-of-service study, to conduct their own cost-of-service studies, and to present other relevant evidence."

On August 8, 2006, South Bend submitted its cost of service study in accordance with the 2006 Rate Order. Clay Customers then moved to immediately terminate the Out-of-Town Differential arguing that the City's August 8, 2006 cost of service study was fatally flawed. Clay Customers attached an affidavit from Kerry A. Heid. The City responded to Clay Customers' Motion, noting that the Motion was procedurally premature and substantively flawed, and sought relief that violated Indiana law. The Presiding Officers denied Clay Customers' Motion in a Docket Entry dated September 15, 2006.

Pursuant to notice and as provided in 170 IAC 1-1.1-15, a Prehearing Conference was convened on September 5, 2006 at 10:00 a.m. in Room E-306 of the Indiana Government Center South, Indianapolis, Indiana. The parties were unable or unwilling to agree on certain aspects of the procedural schedule, including an appropriate test year for the cost of service study. We set forth a procedural schedule in a Prehearing Conference Order issued on September 13, 2006. That Prehearing Conference Order established no requirements with respect to the test year.

In accordance with the Prehearing Conference Order, South Bend submitted the Direct Testimony of John R. Skomp and Michael R. Shaver on November 15, 2006. On November 30, 2006, Clay Customers moved to strike portions of Mr. Skomp's testimony on the basis that the cost of service study in Mr. Skomp's testimony was untimely. South Bend responded to that Motion on December 8, 2006. The Presiding Officers issued a Docket Entry denying Clay Customers' Motion to Strike on December 22, 2006.

On January 12, 2007, South Bend filed an unopposed Motion for Amendment of Procedural Schedule to adjust the remaining deadlines for prefiled testimony to afford South Bend additional time to respond to discovery issued by the OUCC. The Presiding Officers issued a Docket Entry amending the procedural schedule on January 16, 2007.

In accordance with the modified procedural schedule, the OUCC and Clay Customers submitted their prefiled testimony on January 31, 2007. Pursuant to a Docket Entry granting a one day extension of time, South Bend filed its prefiled rebuttal testimony on February 22, 2007. On March 2, 2007, the OUCC filed two motions to strike portions of South Bend's rebuttal testimony. These motions were denied at the evidentiary hearing held in this matter.

On March 6, 2007, at 10:00 a.m., the Commission convened an evidentiary hearing in this Cause in Room E-306, Indiana Government Center South, Indianapolis, Indiana. South Bend, the OUCC and Clay Customers appeared at the evidentiary hearing by their respective counsel and their evidence was admitted into the record. No members of the general public appeared.

Based upon the evidence and applicable law, and being duly advised in the premises,

the Commission now finds as follows:

1. **Commission Notice and Jurisdiction.** Proper legal notice of the hearings held herein was published as required by law. South Bend is a municipally owned utility within the meaning of the Public Service Commission Act, as amended, and is subject to the jurisdiction of the Commission in the manner and to the extent provided by the laws of the State of Indiana. Indiana Code §§ 8-1-2-42 and 8-1.5-3-8 require Commission and City Council approval of changes to South Bend's rates and charges. We convened this subdocket following the issuance of the 2006 Rate Order, to separately review questions raised by the OUCC and Clay Customers about the City's rate structure.

2. **South Bend's Characteristics.** The City owns and operates a municipal water facility serving approximately 42,000 retail customers located within the corporate boundaries of the City as well as unincorporated areas of St. Joseph County.

3. **Evidence.** South Bend, Clay Customers and the OUCC all offered testimony from various witnesses in support of the relief they sought. All testimony was admitted into the record at the March 6, 2007 hearing.

a. **Direct Testimony of South Bend.** Michael R. Shaver, President and Founder of Wabash Scientific, inc., discussed several policy concerns with what he described as firm opposition by the other parties to any rate differential for out-of-town customers. He expressed disagreement with the OUCC's argument in the underlying rate case, Cause No. 42779, that a political boundary is not relevant to assessing the costs to serve various customers. Mr. Shaver testified that the phenomenon of unbundling of municipal services is an appropriate consideration for municipalities in deciding whether to charge out-of-town customers a higher price for those services.

Mr. Shaver explained that unbundling occurs when developers negotiate to receive only a portion of municipal services for their developments located outside of municipal boundaries. Out-of-town residents may choose the services to which they will subscribe rather than paying for the entire bundle of municipal services. Conversely, residents within the boundary must accept the entire bundle of services. As a result, out-of-town residents receive the benefit of lower rates without paying the other costs associated with being part of a larger municipality. He asserted this result is effectively a subsidy, which is easily achieved by moving across a political boundary from a larger city. These residents receive the benefits of "big city services" without paying the higher taxes and utility prices that result from living in a larger city.

Mr. Shaver testified that municipal utilities are not the only services that are unbundled. He indicated that some police and fire services in St. Joseph County are also unbundled. As an example, he noted that the City of South Bend funds a hazardous materials response group, for which the entire county benefits, at the cost of materials. This result can be viewed as a subsidy or a price discount. In addition, according to Mr. Shaver, this subsidy is generally being funded by a population residing inside the city that is less affluent. And, those living outside of the city's boundaries are typically more affluent and are reaping the

benefits.

Mr. Shaver highlighted another concern with unbundling: the payment of uncovered costs by in-town residents. Those living outside of the municipal boundary negotiate services. Any cost (e.g., uncalculated overhead) not covered by the negotiated price will be passed on to those living within the municipal boundary—a group without the luxury of negotiation. Mr. Shaver likened the effect of the political boundary to the owners and non-owners to which the American Water Works Association (“AWWA”) referred in the AWWA Manual:

A government-owned utility may be considered to be the property of the citizens within the city. Customers within the city are owner customers, who must bear the risks and responsibilities of utility ownership. Outside-city customers are non-owner customers and, as such, bear a different responsibility for costs than do owner customers.

*Principals of Rates, Fees and Charges, Manual of Water Supply Practices M1* (Fifth Edition) (hereinafter “AWWA Manual”) at p. 65. Thus, Mr. Shaver concluded, owners, unlike the non-owners, bear the risks and responsibility of utility ownership and should be compensated for their ownership by out-of-town customers through rate differentials. Mr. Shaver stated the AWWA Manual supports charging different, higher rates to out-of-town residents:

A government-owned utility . . . must develop sufficient revenue to meet cash needs . . . However, when that utility serves outside-city, non-owner customers, it is most appropriate to measure the cost of such services on a utility basis; that is, to assign costs to outside-city customers for O&M expense, depreciation expense and an appropriate return on the value of property devoted to serving them.

AWWA Manual at pp. 65-66. Mr. Shaver also noted the AWWA Manual provides that the distinction between owner and non-owner customers may be waived through regulatory policy. *Id.* at p. 66. But, to do so requires some degree of subsidization of utility services. According to Mr. Shaver, subsidization is now a mathematical reality.

Mr. Shaver conducted an analysis of rates for water utilities with rural or small-town customer bases and compared those to South Bend’s rates. The analysis showed that the rate charged by South Bend to out-of-town customers (*i.e.*, those living across the political boundary) would rank in the bottom 5%. Mr. Shaver’s analysis demonstrated that even an out-of-town differential of 100% (as opposed to the 20% differential in South Bend’s rate structure) results in rates being lower than those charged to some rural and small-town residents. He concluded that this data clearly showed the financial advantage of being “close enough” to a city to benefit from its municipal services.

Mr. Shaver rejected the notion that a political boundary was not a valid basis for differentiating utility rates. For example, property taxes differ based on political boundaries. He noted that in 100% of the cases in Indiana, residents inside a municipality pay more in property taxes than those who live outside of the municipality. He also opined that a non-

resident's inability to vote on municipal matters is not a legitimate reason to refrain from implementing a cost differential based on a political boundary. He noted non-residents can request annexation to the municipality. As a result of annexation, services would be re-bundled, and each resident would pay the same for services. However, in Mr. Shaver's opinion, annexation is unlikely because property taxes would increase, which is what non-residents attempted to avoid by moving outside municipal boundaries.

Mr. Shaver noted that the Indiana Supreme Court in *Farley Neighborhood Assoc. v. Town of Speedway*, 765 N.E.2d 1226 (Ind. 2002) accepted the appropriateness of out-of-town differentials. He observed that the Court stated it was "reasonable to charge out-of-town customers for out-of-town operations, maintenance, depreciation, and return on invested capital" and recognized a historical out-of-town rate differential that had been previously applied without objection. According to Mr. Shaver, *Farley* established within the judicial system a "simple, stable, and minimally-invasive" standard of measurement for setting differential utility rates. Mr. Shaver reasoned that if municipal utilities determine that the judicial rate-setting market approved in *Farley* provides a more expeditious and flexible method of rate-setting, it is likely that more municipalities would elect to withdraw from Commission jurisdiction.

Mr. Shaver concluded by recommending the continuation of South Bend's rate structure. He also encouraged the Commission to adopt a policy focused on developing appropriate and fair charges for both non-owners and owners.

John R. Skomp, an Executive with the consulting firm of Crowe Chizek and Company, LLP, offered testimony describing the cost of service study ("Report") prepared to evaluate the propriety of South Bend's existing rate structure. Mr. Skomp explained that the data used to prepare the Report was acquired from South Bend's normal business records except for the pro forma amounts. Those amounts were calculated based on figures derived from the City's business records. In Mr. Skomp's opinion, the type of data used in preparation of the Report is normally found to be reliable and is used in the normal course of business for such purposes.

Mr. Skomp stated that South Bend had selected the twelve months that ended on December 31, 2005 as the test year for the Report. This test year was selected after reviewing South Bend's books and records. Mr. Skomp opined that this test year fairly represents the City's normal operations and, after making the appropriate adjustments, is sufficiently reliable for ratemaking and cost of service purposes. He explained that the City used a December 31, 2005 test year, rather than the same test year at that used in Cause No. 42779, so that the Report was as current as possible.

Mr. Skomp explained several adjustments South Bend proposed to make to test year revenues for purposes of the Report. First, Mr. Skomp proposed to adjust metered sales and irrigation sales to normalize annual revenues for the increase that was granted in the 2006 Rate Order. Second, the Report adjusted various revenue accounts for the revenue that was booked during the test year for sales that occurred outside the test year. Third, Mr. Skomp adjusted South Bend's test year Public Fire Protection and Sprinkler Connection revenues to

include revenue from the current number of customers and connections. Finally, annual revenue from the management fee assessed to South Bend's sewage works was increased to reflect the level found to be appropriate in the 2006 Rate Case.

Several adjustments were also made to South Bend's test year expenses, as reflected in Exhibit D of the Report. South Bend's test year operation and maintenance expenses were increased to reflect current salaries and wages paid to employees. Corresponding adjustment increases were made for contributions paid to the Public Employees Retirement Fund and the Federal Insurance Contribution Act. An adjustment was also made to account for the increase in group insurance costs since the test year. In addition, the Report also accounts for an increase in the annual operation fee paid to the Indiana Department of Environmental Management. Mr. Skomp also made an adjustment to allow for the appropriate level of Payment in Lieu of Taxes ("PILOT") and to properly reflect the Utility Receipts Tax paid by South Bend.

Mr. Skomp stated Section III of the Report contains information about the operation of the City's treatment plant and the water consumption of the customers. The Report contains the monthly pumping data from the treatment plant and calculates the daily average and maximum day totals. It also compares the total monthly sales to the monthly amount of water pumped to calculate the City's unaccounted for water percentage. Mr. Skomp indicated this pumping data was used to calculate the capacity factors that are used in the cost of service study for the Base, Maximum Day, and Maximum Hour allocation.

Mr. Skomp stated Exhibit I of the Report shows the analysis of annual customer consumption by customer class. It also separates the consumption by customers who are inside South Bend's corporate boundaries versus customers who are outside the corporate boundaries. Exhibit J outlines customer data and the calculation of equivalent meters based upon certain assumptions.

Section IV of the Report details Mr. Skomp's cost of service analysis. Mr. Skomp testified that he used the general principles outlined in the AWWA Manual, and he employed procedures designed to allocate the revenue requirements to the appropriate cost function. Exhibit K demonstrates the allocation of the City's plant in service to the various cost categories of Base, Maximum Day, Maximum Hour, Customer Meters and Services, Billing and Collection, Fire Protection Service and Direct costs. The percentage of costs allotted to each cost category was used to allocate some of the specific revenue requirements (e.g., insurance expense, payment in lieu of property taxes, average annual debt service, and extensions and replacements). Mr. Skomp noted that although most of South Bend's plant and equipment could be identified as being located in-town or out-of-town, he identified approximately \$12.3 million of transmission and distribution mains that could not be specifically identified as inside or outside city limits. Mr. Skomp indicated he allocated these expenses to in-town service.

Mr. Skomp testified that Exhibits M and N demonstrate that the 20% outside-city surcharge charged by the City is reasonable and justifiable. Mr. Skomp stated Exhibit M of his Report shows that, on an average basis, the cost of serving the out-of-town customers is

over 115% more than in-town customers. He also indicated Exhibit M does not include an "appropriate return on the value of property devoted to serving" out-of-town customers, which he noted is a general principle outlined in the AWWA Manual.

Mr. Skomp explained that he included Exhibit N in his Report as a different approach to determining an appropriate rate for out-of-town customers. Exhibit N does not require the out-of-town customers to share proportionately in all the costs of operating the plant and equipment located within the City's boundary. Mr. Skomp's Exhibit N assumes that out-of-town customers would pay the directly allocated costs, only a share of Administrative and General Expenses, Source of Supply, Water Treatment and only half the Transmission and Distribution Maximum Day and Hour costs. All remaining costs would be recovered exclusively from in-town customers.

Mr. Skomp testified that he believed the most appropriate manner of establishing a municipally owned water utility's rates for outside-city customers was set forth in Exhibit M. He explained that the purpose of establishing a municipally owned water utility is to serve residents inside the corporate limits, not outside-city customers. When a municipality makes the decision to extend the courtesy of providing its service to residents living outside the corporate limits, the out-of-town customers depend on the existence of the city system for service. Mr. Skomp surmised that when a municipality serves outside its boundaries, all of the costs and expenses of providing service inside the boundaries should be proportionately allocated to out-of-town customers as they are for in-town customers. In addition, out-of-town customers should also pay the direct operation and maintenance expense, depreciation expense, and a return associated with the property dedicated to serving the out-of-town customers. Consequently, Mr. Skomp opined that Exhibit N demonstrates that if there is anything inappropriate about the Out-of-Town Differential, it is that the surcharge is too low.

Mr. Skomp noted that his Report did not allocate to out-of-town customers a return on the value of property dedicated to serving them. Mr. Skomp indicated that had he included this allocation, the surcharge would have been even greater than what is shown in either Exhibit M or N of the Report. Mr. Skomp stated that both Exhibits M and N apply the principles in the AWWA Manual and the only difference between the two exhibits is with regard to the portion of inside-city costs that should be shared by out-of-town customers.

Finally, Mr. Skomp clarified that, although supported by his Report, South Bend was not requesting a change in rates or its rate structure at this time.

b. OUCC's Direct Evidence. OUCC witness Scott A. Bell, Director of the Water/Wastewater Division for the OUCC, offered testimony discussing the City's evidence in support of its Commission-approved Out-of-Town Differential. Mr. Bell began his testimony by expressing his disagreement with Mr. Skomp's use of a 2005 test year for purposes of preparing the Report. Mr. Bell believed Mr. Skomp selected this test year to achieve a higher revenue requirement that justified continuation of the Out-of-Town Differential. Additionally, Mr. Bell took issue with South Bend's description of the Out-of-Town Differential as a surcharge and stated that it is more properly characterized as an out-of-town rate.

Mr. Bell also disagreed with Mr. Skomp's methodology for allocating costs to out-of-town customers. Mr. Bell stated that the AWWA Manual requires inside-city customers to be responsible for all cash requirements left over after assigning all costs to be born by the out-of-town customers. Mr. Bell cited the portion of the AWWA Manual that provides:

when [a] utility serves outside-city, non-owner customers, it is most appropriate to measure the cost of such service on a utility basis; that is, to assign costs to outside-city customers for O&M expense, depreciation expense and an appropriate return on the value of property devoted to serving them. The inside-city customers are then responsible for all remaining cash requirements not derived from outside-city customers.

AWWA Manual at p. 66. Mr. Bell testified that Mr. Skomp failed to make the inside-city customers responsible for all cash requirements remaining after assigning costs to the out-of-town customers. Rather, Mr. Skomp has out-of-town customers sharing or paying for costs that the AWWA Manual states should be paid by inside-city customers.

Mr. Bell disagreed with Mr. Skomp's testimony that his assessment of out-of-town city customers' rate differentials was conservative. According to Mr. Bell, municipalities do not have rates designed to earn a return on their used and useful plant or recover depreciation expense. Rather, they have rates designed to recover money needed for debt service, extensions and replacements. He indicated that if Mr. Skomp applied the AWWA Manual methodology consistently, recovery of debt service would have to be removed if that class of customer was paying for the return on the portion of plant dedicated to providing that class of customer service. Additionally, the out-of-town customer should not pay for replacement and extension expenses if a utility has not opted to recover depreciation costs. Therefore, an out-of-town rate based on return could be less than a rate that does not pay a return.

In order to support his position that the rate differential in South Bend is defective, Mr. Bell highlighted articles that discussed methods for establishing varied rates within the same system (e.g., decreasing-block rate structures, increasing-block rate structures, dedicated-capacity charges, contract rates, seasonal rates and zonal rates). Mr. Bell noted that one article addressing a simple form of zonal pricing, such as that proposed by Petitioner, stated that "these particular rate variances generally have been motivated by political purposes such as taxing nonvoters and inducing annexation, rather than motivated by efficiency considerations.... or justified by actual operating and capacity cost differences." Janice A. Beecher, et al., *Meeting Water Utility Revenue Requirements: Financing and Ratemaking Alternatives*, National Regulatory Research Institute ("NRRI"), (1993) at p. 164. Mr. Bell asserted that utility rates should be based on the cost of providing the service and not on their ability to bring about voluntary annexation, or used as a way to tax non-voters for services.

Mr. Bell criticized both Mr. Skomp and Mr. Shaver for not factoring in the economies of scale gained by the decision to provide service to new customers located beyond the corporate limits. Mr. Bell noted that the 1993 NRRI article noted that conceptually, zonal pricing can be justified because of a customer's distance from the production facilities, but evidence suggests that economies of scale in treatment are created because of regionalization



and system consolidation. According to Mr. Bell, growth in the South Bend area has occurred, and will continue to occur, outside of South Bend. Thus, Petitioner's economies of scale and its current customers (both in-town and out-of-town customers) benefit from out-of-town growth.

Mr. Bell also cited to another article indicating the key issue in implementing zonal rates is one of cost justification. Janice A. Beecher, *Consolidated Water Rates: Issues and Practices in Single-Tariff Pricing*, USEPA and NARUC (Sept. 1999) at p. 14.<sup>1</sup> The article states that more efficient water rates may be attained through unbundling when a considerable cost difference exists within a particular service region. *Id.* In order to gain efficiency, zonal rates must be cost-based as opposed to being based on arbitrary criteria (e.g., rates based solely on geopolitical boundaries). *Id.* However, efficiency is gained only when the price of providing service to different zones can be accurately calculated. *Id.*

According to Mr. Bell, the Petitioner has not presented a purely zonal pricing plan. The Petitioner's zone is based on whether or not a customer resides in South Bend. If annexation occurred, the zone would change. So, out-of-town customers' rates would decrease without a change in service usage or a decrease in the cost of providing service.

Mr. Bell testified that conceivably, South Bend could have created a zonal pricing scheme based on cost. Mr. Bell stated that South Bend has seven treatment facilities located in different areas of the city and different costs associated with each facility. He stated that Petitioner chose not to determine the cost that corresponds to each zone, but instead combined and averaged the costs of the whole system. Consequently, Mr. Bell contended that variances in costs are based on municipal residential status instead of the actual cost of service.

Mr. Bell disagreed with Mr. Shaver's assessment of service rates in South Bend. Specifically, Mr. Bell argued that providing non-utility services to non-residents who do not pay their fair share of the costs for those services should not be used to justify higher water rates to those non-residents. The cost of providing non-utility services does not impact the operational costs to provide water service to customers. Mr. Bell, citing Ind. Code § 8-1.5-3-8, explained that Mr. Shaver's reasoning ignored the statutory basis for municipal rates.

Mr. Bell also disputed Mr. Shaver's assertion that political boundaries make a difference in the cost of providing service. He noted that a water system may have differences in plant as the utility crosses a municipal boundary, and that these differences may affect the cost of providing service to different customers in different locations. However, the mere existence of a municipal boundary does not create higher costs. Mr. Bell argued that cost-causing differences need to be analyzed properly and not just assumed to exist.

Mr. Bell recommended the Commission find that South Bend's Report and evidence do not support its rate structure which imposes a higher rate on outside-city customers, based on whether the customer is located beyond the municipal boundary.

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<sup>1</sup> This report was prepared as a joint publication for the U.S. Environmental Protection Agency ("USEPA") and the National Association of Utility Regulatory Commissioners ("NARUC").

Judith I. Gemmecke, a Senior Utility Analyst with the OUCC and a certified public accountant, offered testimony on the OUCC's behalf. She sought to dissuade the Commission from accepting South Bend's updated revenue requirements. Specifically, Ms. Gemmecke stated that South Bend's revenue requirement is partially based on projects and debt service that have not been analyzed or otherwise approved.

Ms. Gemmecke accepted most of Petitioner's adjustments to the 2005 operating expenses. Ms. Gemmecke made an adjustment for PILOT which is designed to allow the utility to collect the property taxes it would have received if it were investor-owned. However, property located outside of the city limits is not taxed by the city. Thus, she stated Petitioner cannot recover the taxes it would have received from property outside of the city limits. Ms. Gemmecke also eliminated Petitioner's expenses for the Report and previous rate case as she believed these were non-recurring expenses. Ms. Gemmecke also proposed to capitalize expenses incurred conducting a leak detection survey, because the survey is generally not performed annually. Regarding the utility tax receipts, Ms. Gemmecke noted the only difference between the Petitioner's and the OUCC's calculation was the amount of receipts on which the tax is applied.

Ms. Gemmecke noted additional revenue requirement differences. She asserted that Petitioner, in its calculations, increased its debt service and used depreciation instead of extensions and replacements ("E & R"). Ms. Gemmecke stated she used amounts for E & R and debt service approved in the rate case. She opined that any other amount would be speculative because a final decision on the debt and the depreciation expense is outside of the scope of this case. Additionally, Ms. Gemmecke reduced revenue requirements by the interest and rental income earned from water property in 2005. She indicated these expenses are typically considered in rate-making formulas, because they have associated expenses included in the utility's revenue requirements.

As a result of Ms. Gemmecke's adjustments, the Petitioner's test year revenues were reduced by about \$166,000. She noted a further adjustment was made to reallocate among all customers the amount of revenues that would have been collected from outside city customers above the amount charged to inside city customers.

Ms. Gemmecke also testified that during an on-site review, she checked the accuracy of the consumption data by class. She examined the consumption data for the top 25 water users in the residential class. As a result of her examination, Ms. Gemmecke found errors that included bad readings, misclassified service and a billing error. Ms. Gemmecke expressed concern that this type of detail could affect the outcome of a cost of service study.

Finally, Ms. Gemmecke offered her opinion that a 2005 test year was not more appropriate than a 2004 test year. She noted that the revenues and expenses proposed in the Report were not previously reviewed by the OUCC or approved by the Commission. Ms. Gemmecke asserted that since the purpose of this proceeding was to evaluate the appropriateness of the City's rate structure, 2004 is the appropriate test year, not 2005; South Bend's current rate structure is based on revenue from 2004.

c. Clay Customers' Evidence. Kerry A. Heid offered testimony on behalf of the Clay Customers. Mr. Heid stated that the Commission, by establishing this subdocket, placed on South Bend the burden of justifying its existing rate structure, including the Out-of-Town Differential. Ultimately, Mr. Heid believes that the Out-of-Town Differential should be eliminated.

Mr. Heid began by criticizing Petitioner's use of 2005 as the test year as opposed to 2004. He argued that a utility ordered to establish the reasonableness of its existing rate structure should use the revenue requirement and volumes that are the underlying basis for those rates. Mr. Heid expressed concern that the underlying data used by Petitioner, which had not been subject to scrutiny in a rate case, would distort the results of the Report and that the increase in the revenue requirement was too great to draw any meaningful conclusions regarding the existing rates.

Mr. Heid analyzed the Petitioner's data and noted areas of disagreement that exist in the underlying data contained in the Report. For example, he noted Mr. Skomp included in his Report the bond debt service and PILOT for a total of \$930,784 in revenue requirements. But, Mr. Heid noted that this amount is for a project that South Bend is not proposing and may never pursue. He stated this amount would have a significant effect on the Report and should not have been included. Also, the Petitioner calculated its debt service requirement by using a five-year average even though the Commission previously required a three-year average. As a result of these discrepancies, Mr. Heid believes Petitioner's data cannot be trusted to be fair and accurate. Mr. Heid concluded the cost of service study should be rejected.

Mr. Heid next criticized South Bend's cost of service study methodology because it did not follow the AWWA Manual's principles for establishing water rates even though the Commission encouraged compliance with the AWWA Manual. Mr. Heid testified that according to the AWWA Manual, customers inside the city are owners and customers outside the city are non-owners. Since owners shoulder the burden and risk of managing the system, they should receive some benefit for this added responsibility. Consequently, nonresident rates should be based on a return on the value of the portion of the plant allocated to providing them service. He stated that the AWWA Manual's distinction between inside and outside rates is based solely on political boundaries as opposed to physical cost differences between serving the inside customers compared to the outside customers.

Mr. Heid contends that Mr. Skomp did not follow the AWWA Manual methodology, but instead attempted to calculate the physical cost differences between servicing inside and outside customers. Citing to the Commission's February 18, 2004 Order in *Petition of the City of Evansville*, Cause No. 42176 (the "Evansville Order"), Mr. Heid stated the Commission has previously found this approach to be rife with problems. He testified that, as an example, there is no difference in the physical cost of serving two neighboring customers, one of whom is inside the city limits and the other located just across the city limits. Mr. Heid pointed out that in South Bend, some outside-city customers reside closer to treatment facilities and require fewer facilities than some inside-city customers. He further noted that even if the city's boundaries change (e.g., annexation), the physical cost of servicing affected

customers remains the same. Therefore, Mr. Heid asserts the Petitioner's boundary is an arbitrarily drawn line and not based on the actual cost of providing service.

Mr. Heid stated the AWWA Manual supports a political boundary based on the actual cost of service to customers. He explained that the AWWA Manual requires class-based identification of inside-city and outside-city customers. For instance, utilities need to identify inside residential, outside residential, inside commercial, outside commercial, inside industrial and outside industrial groups of customers. Then, the service costs would be calculated for each class of customers as provided in the AWWA Manual at p. 63.<sup>2</sup> Mr. Heid noted that Petitioner's prior cost of service study complied with this methodology, but that Mr. Skomp's cost of service study submitted in this Cause did not. In Mr. Heid's opinion, Mr. Skomp's use of an across-the-board percentage, rather than a customer class methodology, to determine the outside users' surcharge is contrary to the AWWA Manual methodology and leads to inequitable results.

Mr. Heid noted Petitioner offered Exhibits M and N to support the surcharge for outside-city customers. According to Mr. Heid, these exhibits are inconsistent with the AWWA Manual's methodology for calculating rates. Mr. Heid asserted that Exhibits M and N are flawed because: (1) both exhibits exclude customer and fire protection costs, which results in the exclusion of 31% of total revenue requirements, and (2) both exhibits rely on a direct allocation of revenue requirements to outside-city customers that improperly included PILOT assessed on outside-city plant and contributions in aid of construction.

Mr. Heid continued to criticize Exhibits M and N by stating that even if Mr. Skomp's approach were accepted, the exhibits are still "fundamentally and fatally flawed." Mr. Heid disagreed with Mr. Skomp's allocation of costs between municipal and non-municipal customers on a volumetric basis—as if they were entirely base costs. Mr. Heid opined that the costs should have been functionalized into base maximum day and maximum hour costs. Then, each cost should have been allocated to the appropriate customer class based on the class's usage.

According to Mr. Heid, Exhibit M improperly assigned costs to customers. He testified that the methodology in Exhibit M assumes the utility plant located outside the city limits benefits only the out-of-town customers and that the utility plant located inside the city limits benefits all customers. Mr. Heid opined that this methodology was rejected by the Commission in the Evansville Order (at pp. 27-28). With respect to Exhibit N, Mr. Heid noted that Mr. Skomp assigned some costs solely to inside customers, but contended that such assignment was done arbitrarily and without providing any support for the assignment. Therefore, Mr. Heid reasoned that both exhibits should be rejected.

Mr. Heid also testified that Exhibit Q of Petitioner's Report incorrectly assigned units of service to rate blocks, instead of creating units of service, or allocation factors, for different

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<sup>2</sup> Intervenors provided a cost of service study prepared by Black & Veatch Consulting Engineers for Lawrence, Kansas. According to Mr. Heid, this study correctly used the methodology described by the AWWA Manual. See Intervenor's Exhibit KAH-S3.

customer classes. Mr. Heid also did not believe the Report's capacity factors for maximum hour and maximum day demand were supported. Mr. Heid explained that each customer class's maximum rate of use serves as a guide for assigning capacity-related costs to customer classes. The capacity factors for each class essentially allow the allotment of maximum day and hour costs to the proper customer class. As a result, capacity factors are the largest component in the creation of costs for each customer class. Mr. Heid expressed concern that the capacity factors had changed dramatically from the last rate case to the current case and lacked support for the derivation of the factors. He also expressed concern with the Annual Use column in Exhibit Q that reflects the assumption of a 50% outside city surcharge, which also affects the calculation of the maximum day and hour units of service.

Mr. Heid also responded to Mr. Shaver's testimony. He noted that Mr. Shaver's basic premise was that since outside-city customers receive some municipal services without paying municipal taxes, then they should pay more (*i.e.*, a surcharge) for water service. In Mr. Heid's opinion, discussion of other municipal services is irrelevant to the establishment of utility rates. Mr. Heid also took issue with Mr. Shaver's assertion that OUCC policy subordinates the interests of the majority (*i.e.*, the inside-city customers) over the interests of the minority (*i.e.*, the outside-city customers) by indicating that Mr. Shaver fails to recognize the lack of political voice or recourse of out-of-town customers.

Mr. Heid concluded that the Out-of-Town Differential should be rejected because the Report did not support it.

d. South Bend's Rebuttal Testimony. Mr. Shaver offered rebuttal testimony for South Bend. Mr. Shaver disagreed with Messrs. Bell's and Heid's characterizations of his direct testimony that an out-of-town differential was appropriate to compensate municipalities for other, uncompensated municipal services. Instead, Mr. Shaver was only stating that out-of-town differentials should be used to recover water-related costs. His testimony regarding uncompensated services served only to demonstrate that a political boundary is not purely arbitrary when considering costs.

Mr. Shaver testified that political boundaries are important because out-of-town customers receive services that are unbundled, which causes a subsidy for those customers. Mr. Shaver attached to his rebuttal testimony an independent study prepared by Dr. Hojnacki of the School of Public and Environmental Affairs Institute for Applied Community Research, Indiana University—South Bend. Dr. Hojnacki's study was requested by St. Joseph County, Indiana to evaluate the per capita costs of providing categories of services in that county. Dr. Hojnacki concluded that,

it is very clear that residents of South Bend carry a disproportionate share of the burden in such areas as public safety, development/redevelopment and civic amenities, with Mishawaka residents not far behind. Residents of the unincorporated areas of St. Joseph County, on the other hand, get many of the benefits of urban living but pay a very small portion of the costs.

William P. Hojnacki, *Paying for Public services in St. Joseph County: Benefits v. Burden*,

(Sept. 2006), pp. 10-11.

Mr. Shaver testified that contrary to the assertions of the Respondents' witnesses, he did not testify that water rates should be used to repay the costs of uncompensated municipal services. Instead, it was his testimony that municipal utility services are consistently the first municipal service to be unbundled because they enable urban developmental densities to be replicated in unincorporated areas. Once municipal utility services are unbundled, Mr. Shaver explained that a chain of developmental events is set in motion leading to urban blight and disproportionate financial impacts accruing to poorer urban populations. So, when agencies make policy decisions, they need to understand the direct relationship between the unbundling of services and other adverse community impacts.

Mr. Shaver surmised that if the Commission ignored the impacts of municipal unbundling as irrelevant and adopted a policy that makes it difficult for a municipality to support an out-of-town rate differential, the Commission may become more isolated as municipalities chose to withdraw from Commission jurisdiction and elect to be subject to trial court review of rate disputes. Mr. Shaver stated that municipalities will enjoy several benefits from withdrawing from Commission jurisdiction if the Commission adopts the position advocated by the OUCC and Clay Customers, including (1) lower costs, (2) faster implementation of increased rates, and (3) flexibility to rely on their rate consultants. Mr. Shaver acknowledged the Commission had a positive role to play in protecting against rate abuses. But, he cautioned that municipalities were likely to forget or ignore that positive role if the Commission adopts a policy that makes justification of out-of-town rates difficult or impossible.

Mr. Shaver next responded to Mr. Bell's citation of a NRRI publication to support the OUCC's opposition to inside/outside rate-setting. Mr. Shaver indicated reliance on this NRRI publication was flawed for a number of reasons. First, NRRI included a disclaimer at the beginning of the publication that explained that the opinions therein are those of the author and not those of the NRRI. Second, the publication had not been updated since 1993, so the information is outdated. Third, Mr. Bell takes his quote out of context. Mr. Shaver stated that the publication's discussion of out-of-town rate differentials simply demonstrated the possible disadvantages of zonal rates. The report does not say that South Bend's system was affected by such disadvantages or that all zonal rate systems should be disallowed because of such problems. Mr. Shaver noted that the publication acknowledges the potential validity of inside/outside rate systems but cautions rate-setting agencies to be aware of the strengths and weaknesses of any rate system, including zonal rates.

Mr. Shaver stated that while the OUCC's and Clay Customers' witnesses had spent a great deal of effort criticizing the Report, the testimony seemed to assume that inside/outside rates are proper and most appropriate under the AWWA Manual. Mr. Shaver disagreed with Mr. Heid's suggestion that Mr. Shaver's reliance on the AWWA Manual meant that Mr. Shaver supported Mr. Heid's method for calculating rates. Mr. Shaver testified that he offered no opinion as to how rates should be calculated.

Finally, Mr. Shaver noted that the opposing testimony from Messrs. Bell and Heid

criticized Mr. Skomp's rate calculations without quantifying the actual magnitude of the mathematical difference between his calculation and the calculation that would result if the method of Messrs. Bell and Heid were used. Mr. Shaver noted that the absence of a competing rate calculation that used the methods recommended by Messrs. Bell and Heid left the Commission without a reasonable basis to evaluate whether the arguments were actually material to the outcome. Mr. Shaver noted that all parties, in addition to the Indiana Supreme Court and AWWA, agreed that the AWWA Manual allows municipal utilities to charge out-of-town customers for such items as operating costs, depreciation and return on investment in order to serve outside customers. Yet, he noted, Mr. Heid and the OUCC seek summary rejection of the Out-of-Town Differential. Mr. Shaver suggested that the City, as well as the Commission, would benefit from knowing the mathematical difference between Mr. Skomp's proposed methodology and that of Messrs. Bell and Heid.

Mr. Skomp began his rebuttal testimony by pointing out that only the Petitioners completed a cost of service study. He noted that neither the OUCC nor Clay Customers performed their own cost of service study, but instead merely criticized Petitioner's Report. Mr. Skomp also noted that even though the OUCC and Clay Customers proposed eliminating the existing rate structure, they offered no evidence to show that their suggested rate structure is cost-based; no evidence that outside-city customers' rates should be reduced; and no acknowledgment that the elimination of the rate differential would lead to a subsidy for outside-city customers.

Mr. Skomp described some revisions to the Report that were necessary, but he emphasized that the changes did not have a material outcome on the findings. Mr. Skomp's most significant revision to the Report was to ensure that Exhibit K properly allocated the Source of Supply and Pumping Plant and the Water Treatment Plant located outside the city limits. Mr. Skomp originally assumed the source of supply infrastructure physically located outside the city limits was used to provide service to both in- and out-of-town customers. However, he later discovered that this infrastructure does not provide any service to in-town customers. Therefore, the Report was revised to allocate these costs to out-of-town customers.

Mr. Skomp then turned to the issues raised by Ms. Gemmecke. He drew attention to portions of Ms. Gemmecke's assertion that errors exist in the Report. He cited as an example, a variance she noted in the consumption data analysis that could have affected the outcome of a cost of service study. Mr. Skomp explained that his analysis established that the variance was immaterial and therefore would not have materially affected the outcome of the cost-of-service study. Ms. Gemmecke also stated that the largest recorded monthly usage was attributable to a faulty reading. Mr. Skomp explained that South Bend had already determined this reading was in error and removed the data from the calculation of consumption data. He stated that although the OUCC expressed concern that these errors in the consumption data might have affected the outcome of the cost of service study, the OUCC stopped short of determining if it actually had an effect on the study. Mr. Skomp asserted that the OUCC could have made a determination because it had access to the data used in creating the calculations.

Mr. Skomp also criticized the OUCC for, on the one hand, disapproving of South Bend's use of 2005 test year data while, on the other hand, selecting some information from that test year that made it appear that the rate differential could be eliminated without causing an increase in charges to in-town customers. Mr. Skomp declared that Ms. Gemmecke's mixture of 2005 test year data and data from the test year that was used in the 2006 Rate Order violates the basic accounting tenet of matching. He explained that Ms. Gemmecke uses a different period for measuring revenues than she does for measuring some of the revenue requirements. He also surmised that she did so in order to eliminate the surcharge without a corresponding increase to inside customers through an overall rate decrease.

Mr. Skomp also objected to Ms. Gemmecke's adjustment to PILOT. Ms. Gemmecke removed the projects funded by the 2006 and 2007 Water Revenue Bonds from the calculation of PILOT. According to Mr. Skomp, the 2006 Bonds project will be in service. He also indicated the project costs associated with the 2007 Bonds are expected to be expended in the near future and will have an effect on the annual PILOT paid to South Bend.

Mr. Skomp contested Ms. Gemmecke's adjustment for Non-Recurring Rate Case Expense. Ms. Gemmecke proposed the removal of accounting, legal and engineering invoices on the basis that such costs occur once in the lifetime of a particular rate study and should be compensated as a rate case expense in its debt issuance. Mr. Skomp countered that the accounting and legal fees far exceeded the expenses included in the debt issuance. He stated expenses continue to grow because consulting and legal services were used throughout 2006 and continued into 2007. Accordingly, he argued these costs should be included.

Mr. Skomp also rejected Ms. Gemmecke's adjustment for non-recurring expenses to eliminate the cost of a leak detection survey because it is not performed annually. Mr. Skomp agreed that such a survey was not performed annually but noted that it was performed every two years and that, at a minimum, it should be amortized over its useful life. He further noted that the costs of ongoing meter inspection tests were not included, and the Utility had spent approximately \$71,000 at the time the rebuttal testimony was filed. Since the cost of several studies had not been included, Mr. Skomp opined that \$64,000 is reasonably representative of an ongoing level of study and testing that is annually performed by South Bend.

Mr. Skomp also disagreed with Ms. Gemmecke's proposal to remove the additional proposed debt and updated capital improvement plan revenue requirements. Mr. Skomp testified that South Bend anticipates requesting Commission authority to approve this debt issuance. Finally, he also criticized Ms. Gemmecke for proposing elimination of the Out-of-Town Differential without providing appropriate cost justification.

Mr. Skomp next turned to Mr. Bell's criticisms. He observed first that Mr. Bell did not provide independent analysis of what he believes would be an appropriate rate structure for South Bend. Mr. Skomp opined that absent this analysis, Mr. Bell cannot justify the elimination of the Out-of-Town Differential.

Mr. Skomp observed that South Bend's current rate structure was approved by the Commission in its January 27, 1993 Order in Cause No. 39554. He also noted that neither the



OUCG nor Clay Customers filed any type of cost of service analysis in this cause that would allow the Commission to eliminate the Out-of-Town Differential. Mr. Skomp agreed with Mr. Bell's prefiled testimony that any rate structure approved for use by a utility company should be cost based and opined that any recommendation to eliminate South Bend's rate structure without a cost of service analysis would conflict with Mr. Bell's testimony.

Mr. Skomp stated that Mr. Bell's testimony described in detail how he believes an out-of-town differential should be computed but does not provide any calculations demonstrating the process. Mr. Skomp indicated his belief that the OUCG's approach in this subdocket is to assume that South Bend bears the burden of proof in justifying the continuation of the Out-of-Town Differential. He stated this position is at odds with the AWWA Manual which provides:

[a] basic tenet of the law involving municipal rate setting is that rates established in a lawful manner by a municipality or municipal authority are presumed to be reasonable, fair and lawful. A presumption of validity is accorded rates enacted by municipal ordinance and those challenging the rates bear the heavy burden of proving that the rates charged are unjustly discriminatory or unreasonable.

AWWA Manual at p. 280.

Mr. Skomp also noted that Mr. Bell and Mr. Heid presented different methods for computing an out-of-town differential. Both Mssrs. Heid and Bell claim their divergent methodologies are consistent with the AWWA Manual and assert that Mr. Skomp's methodology does not comply with the AWWA Manual. In Mr. Skomp's opinion, this was not surprising because the AWWA Manual is designed to provide guidance and advice; it is not a rulebook for calculating rates. Therefore, rate professionals often take different approaches when calculating rates and charges, and they may still be in compliance with the AWWA Manual.

Mr. Skomp criticized Mr. Heid's overall approach of criticizing the Report and advocating elimination of the Out-of-Town Differential based solely on that criticism rather than an alternative, cost-based rate structure. Mr. Skomp also disagreed with Mr. Heid's assertion that the Commission placed the burden on South Bend to justify its existing rate structure. Mr. Skomp testified that this is inconsistent with the Commission's directives contained in the 2006 Rate Order, as well as the AWWA Manual. Mr. Skomp pointed out the portion of the 2006 Rate Order Mr. Heid cited as supporting his conclusion did not assign the burden of proof. In the 2006 Rate Order, the Commission acknowledged that the OUCG and Clay Customers had raised a number of questions about the propriety of South Bend's existing rate structure, but ultimately concluded that those questions were insufficient to overcome the Commission's historic reliance on the presumptive validity of an existing cost-of-service study. If South Bend bore the burden to support its existing rate structure, Mr. Skomp noted that the mere presence of these questions would have been sufficient to support elimination of that rate structure.

Mr. Skomp criticized Mr. Heid for his inconsistent positions when discussing disagreements with cost of service studies. Mr. Skomp noted that in this case, Mr. Heid testified that flaws in the Report justified elimination of South Bend's long-standing Out-of-Town Differential. In *City of Evansville*, Cause No. 42176, Mr. Heid took exactly the opposite position. He maintained that the party who proposed to change the historical rate structure must prove that the change is necessary. Mr. Heid took yet another position when he testified in support of the City of Indianapolis's cost of service study in Cause No. 43056. There, he criticized the other parties' proposed rejection of the cost of service study as self-serving. He stated that the proper course would be for the cost of service study to simply be revised to respond to specific criticisms rather than entirely rejected. Mr. Skomp surmised that here, as in Mr. Heid's City of Indianapolis case, those who simply criticize South Bend's Report have a self-serving motive: they want to eliminate the Out-of-Town Differential without offering any cost support as justification for its elimination.

Mr. Skomp also refuted Mr. Heid's assertions that a cost of service study based on a test year that is different from the test year used to determine the rates renders the study meaningless. Mr. Skomp testified that Mr. Heid admitted in his deposition that his opinion concerning the appropriate test year is his own opinion and not derived from the AWWA Manual. Moreover, Mr. Skomp explained that Mr. Heid confuses the issue by incorrectly using the terms rate and rate structure interchangeably. He stated the distinction is important because this subdocket is examining the appropriateness of South Bend's rate structure based on an updated test year, not the appropriateness of its rates.

Mr. Skomp challenged Mr. Heid's assertion that, according to the AWWA Manual, an across-the-board percentage for outside-city rate differentials is inappropriate. First, he noted that a majority of members of the AWWA's Rates and Charges Subcommittee utilize an across-the-board percentage for its outside-city rate differentials. Second, he stated that none of the AWWA seminars he has attended has endorsed a single method for calculating outside-city rate differentials. Rather, they have instructed in a variety of ways to approach the issue.

Mr. Skomp also addressed claims his attempt to quantify the physical cost differences between serving inside customers compared to outside customers was futile. He noted that the AWWA Manual specifically directs that these costs be quantified and identified, directing the professional "to assign costs to outside-city customers for O&M expense, depreciation expense and an appropriate return on the value of property devoted to serving them." AWWA Manual at p. 66.

Mr. Skomp disagreed with Mr. Heid that the Report should have functionalized the costs shown in Exhibits M and N into base, maximum hour, and maximum day costs before allocating them to various customer classes. Mr. Skomp reiterated there was more than one way to assign costs. Mr. Skomp stressed again that he allocated costs in the way that the AWWA Manual prescribes: outside-city customers pay the costs directly associated with serving them.

Responding to Mr. Heid's concerns about the various inputs or assumptions used in the Report, Mr. Skomp observed that Mr. Heid failed to demonstrate how any of these

concerns would affect the overall outcome of a review of the appropriate rate structure for South Bend. Although Mr. Skomp acknowledged the capacity factors he used have changed significantly since the Commission's Order in Cause No. 39554, he noted that no evidence that the changes were significant. According to Mr. Skomp, Mr. Heid could have properly addressed and supported his concerns and criticisms by performing his own cost of service study.

Mr. Skomp also disputed the criticism of his assumption that 50% of maximum day and maximum hour transmission distribution costs are allocable to all customers. He explained that 100% of the in-town transmission and distribution costs are allocable to out-of-town services because they depend upon the in-town system for their service. Mr. Skomp observed that the converse is not true. He stated he prepared Exhibit N to show precisely how reasonable the current 20% surcharge is to the out-of-town customers.

4. **Commission Discussion and Findings.** As we indicated earlier, the Commission created this subdocket because the OUCC and Clay Customers raised several concerns with South Bend's rate structure in Cause No. 42779. In that Cause, we determined those concerns "might, *with sufficient supporting evidence*, lead to a conclusion that the City's [Out-of-Town Differential] is not cost-based." 2006 Rate Order at 16 (emphasis added). However, "[t]he OUCC and Clay Customers [had] not presented evidence to show that, even if all of [their] arguments are true, there is no justification, based on what it costs the City to provide water service, for imposition of the [Out-of-Town Differential]." *Id.* We concluded that "[u]ntil we have evidence to show otherwise, it is reasonable to assume that the cost differences used to justify the existing [Out-of-Town Differential] remain relevant." *Id.* Consequently, we initiated this subdocket for the purposes of investigating, through an examination of a cost-of-service study or studies for water service, whether the City's rate structure is appropriate or should be changed.

As the Commission noted in the Evansville Order, the petitioning party, as the proponent of change, bears the burden of proof to demonstrate it is entitled to the relief it is requesting. Evansville Order at 32. *See also, General Motors Corp. v. Indianapolis Power & Light Co.*, 654 N.E.2d 752, 759 (Ind. Ct. App. 1995) (holding party petitioning for relief bears the burden of proof). This position is also consistent with the Administrative Order and Procedures Act, which provides that in administrative proceedings, "the agency or other person requesting that an agency take action...has the burden of persuasion and the burden of going forward with the proof of the request...." Ind. Code § 4-21.5-3-14(c). However, there is no petitioning party in this Cause. Rather, this subdocket is a Commission investigation into the City's rate structure. In such a proceeding (and as indicated in the Commission's Order initiating this subdocket), the burden is on all parties to place evidence before the Commission necessary for it to make a determination of what South Bend's rate structure should be on a prospective basis. *See also, In re Commission Investigation of the Rates and Charges of Northern Ind. Public Serv. Co.*, Cause No. 41746 (IURC, August 29, 2001).

In an attempt to allow the OUCC and Clay Customers to further support the concerns raised in the underlying Cause, the starting point of the Commission's investigation was to be a new cost of service study prepared by the City. Mr. Skomp prepared and submitted a cost

of service study which supported continuation of the Out-of-Town Differential. Mr. Skomp testified that his methodology complied with the AWWA Manual's guidance. His Report concluded the existing Out-of-Town Differential was cost based and that South Bend could justify a much higher differential to out-of-town customers. The OUCC and the Clay Customers, however, presented several arguments as to why the Commission should reject the City's cost of service study.

Based on the evidence presented, we agree with many of the assertions made by the OUCC and Clay Customers concerning the Report. As an initial matter, we note that while the use of an updated test year may not have been wholly inappropriate, we agree with the OUCC that the City's adjustments made it difficult to evaluate the cost of service study and the appropriateness of the rate structure in question. Both the OUCC and Clay Customers raised issues and expressed disagreement with several of the Petitioner's proposed adjustments to the City's expenses and revenue requirements. For example, Mr. Heid questioned the inclusion of \$930,784 for a project for which the City had not yet (and, we note, still has not) sought Commission approval and the use of a five-year (rather than the previously approved three-year) average for calculating debt service. Intervenor's Exhibit KAH-S, p. 8-9. We agree with the OUCC and Clay Customers that a cost of service study is only as good as its underlying data. If the underlying data is not accurate, the cost of service results will be distorted. The distortion may be greater or smaller depending on the cost of service component (*e.g.*, chemical expense, improvement project, etc.) since each component is allocated differently to the customer classes. Therefore, inappropriate adjustments could significantly affect a cost of service analysis. However, because we find the City's cost of service study to be flawed in other areas, we need not further address the City's proposed revenue adjustments.

For the primary reasons set forth below, the Commission finds that the City's cost of service study contains key flaws and cannot be reasonably relied upon to determine an appropriate rate structure. First, South Bend has failed to adequately support the capacity factors used in its Report. The use of appropriate capacity factors is important in a cost of service study because capacity factors are the single largest driver of costs for each customer class. As Mr. Heid explained, each customer class's relative maximum rate of use serves as the basis for allocating capacity-related costs to customer classes. The rationale being that customers with a high peak rate of use as compared to customers with an average rate of use require larger capacity pumps, mains and certain other system facilities than a customer who has the same total volume of use but takes water at a uniform rate. Consequently, because each customer class's maximum day and maximum hour capacity factors are effectively its cost allocation factors, inaccuracies in the capacity factors will result in errors in cost allocation.

South Bend offered little evidence to support the reasonableness of the capacity factors utilized in the Report. As Mr. Heid noted in his direct testimony, several of the capacity factors have changed significantly from the 1992 rate case. South Bend offered no explanation for the proposed change in its capacity factors. South Bend also offered little support for the derivation of its proposed capacity factors and no support for its decision to use the same capacity factors for both inside and outside city customers when it admits such

use is unsupported by its own data. Petitioner's Exhibit JRS-S1-R, p. 76. Because we lack the necessary evidence to determine the validity of the City's proposed capacity factors, we are unable to review the appropriateness of any cost allocation.

Second, the City's Report failed to follow the guidance set forth in the AWWA Manual with respect to establishing outside city rates. As noted by the parties, the AWWA Manual at p. 65-66 states,

A government-owned utility may be considered to be the property of the citizens within the city. Customers within the city are owner customers, who must bear the risks and responsibilities of utility ownership. Outside-city customers are non-owner customers and, as such, bear a different responsibility for costs than do owner customers.

The costs to be borne by outside-city (non-owner) customers are similar to those attributed to the customers (non-owners) of an investor-owned utility. Such costs include O&M expense, depreciation expense, and an appropriate return on the value of property devoted to serving the outside-city customers.

\* \* \*

The inside-city customers are then responsible for all remaining cash requirements not derived from outside-city customers.

As Mr. Heid explained, the premise for this approach is that the municipality bears all the burdens and responsibilities of managing the system. Therefore, the residents of the municipality should receive some benefit for this added responsibility. It is for this reason that the nonresident rates should be based on a return on the value of that part of the plant value allocated to nonresident customers. The municipal utility has an ownership interest in the facilities used to provide service and should be entitled to earn a fair and reasonable return on its investment. The utility basis of establishing costs of service to non-owners acknowledges city ownership and equity interests in the utility system, yet allows reasonable rates for outside city service through the recognition of a fair return.

Instead of following the AWWA methodology, the City fails to assign to inside city customers all cash requirements left over after assigning costs to outside city customers. As noted by Mr. Bell, Petitioner's Exhibit M and N, which allocates the total revenue requirement between inside and outside city customers, does not make the inside city customer responsible for all cash requirements remaining after assigning costs to the outside customers. Rather, these exhibits assign direct costs to the outside city customers and then has the outside city customer share, in whole (as reflected in Exhibit M) or in part (as reflected in Exhibit N), the costs that the AWWA Manual states should be born entirely by the inside city customers.

The methodology used in the City's Report does not materially differ from the methodology that we rejected in the *Petition of the City of Evansville*, Cause No. 42176. Like

the cost of service study in *Evansville*, the City's Report assumes that all (as reflected in Exhibit M) or part<sup>3</sup> (as reflected in Exhibit N) of the plant located within the municipal limits should be considered to provide service equally to the outside city customers and the inside city customers. The Report also assumes that all of the plant located outside the city limits provides no benefit to inside city customers. And, although Mr. Skomp asserted that the City could identify the location of the majority of the plant as being either inside or outside the city, it is unclear from the evidence presented whether the Report's assumptions are reasonably valid given the fact that the utility is a functionally integrated utility.

Moreover, the basic cost of service principles require the identification of each inside city and outside city customer class, which South Bend's Report failed to do. In order to determine the cost to serve each customer class, it is first necessary to identify inside residential, inside commercial, inside industrial, outside residential, outside commercial and outside industrial customer classes. The derivation of the cost to serve each customer class is fundamental to any cost of service study. As Mr. Heid explained, without separate customer classes, it is simply not possible to determine the cost of providing service to the outside city customers. As the Commission found in the *Evansville* Order, the failure to determine the cost of providing service to outside customers is a critical flaw.

In addition, both Exhibit M and Exhibit N are flawed because they each allocate all costs between inside and outside customers on a volumetric basis (i.e. as if the costs were all base costs). We agree with Mr. Heid that the correct approach would have been to allocate the maximum day costs between inside and outside city customer classes based on the relative maximum day extra capacity units of service and to allocate the maximum hour costs between inside and outside city customer classes based on the relative maximum hour extra capacity units of service.

Finally, while the OUCC and Clay Customers provided substantial evidence in support of their position that the City's Report is flawed and cannot be relied upon to support the Out-of-Town Differential, neither party provided evidence to support their position that the Out-of-Town Differential should be eliminated. Neither the Clay Customers nor the OUCC prepared or submitted a cost of service study. Nor did they offer adjustments to the City's Report to reflect the changes in assumptions or approach they believed to be appropriate. Furthermore, they did not provide any additional evidence concerning the questions raised in the underlying Cause.<sup>4</sup>

Rather, the OUCC and Clay Customers appear to rely on the Commission's February 18, 2004 Order in *City of Evansville*, Cause No. 42176, in support of their request that we simply eliminate the Out-of-Town Differential. *Evansville* does not support such a result. In *Evansville*, it was the petitioner who proposed to implement the surcharge for the first time and bore the burden of proving such a surcharge was appropriate before the Commission could approve its application; here we approved the Out-of-Town Differential fifteen years

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<sup>3</sup> We would also note that the City provided no meaningful analysis to explain how it determined the portion of the inside city plant that should be shared.

<sup>4</sup> See 2006 Rate Order at 16.

ago and affirmed its continuation in the 2006 Rate Order. Elimination of the City's existing and approved rate structure in favor of one that has been not been justified by any evidence would be inappropriate for several reasons. First, to do so would be at odds with our findings in the 2006 Rate Order in which we refused to invalidate South Bend's rate structure, on the basis that the questions raised were insufficient to overcome the presumption that South Bend's existing rate structure was reasonable. *See* 2006 Rate Order at 16.

Second, it would be inconsistent with our practice of requiring cost support for any approved rate structure. *See, In re Petition of the Board of Directors for Utilities of the Department of Public Utilities of The City of Indianapolis*, Cause No. 39066 at 31 (IURC, Nov. 1, 1991) (acknowledging that the Commission is not statutorily mandated to base rate design solely upon a cost of service study, but that it has consistently held the position that utility rates should be designed to the maximum extent practicable to reflect the cost of providing service). No party testified that elimination of the Out-of-Town Differential would be cost based. Consequently, we cannot agree that the evidence in this proceeding supports revising South Bend's rate structure to eliminate the Out-of-Town Rate Differential, particularly lacking evidence as to whether elimination will result in the subsidization of costs by the in-town customers.

Therefore, as neither party provided any cost of service evidence by which the Commission could determine that a different rate structure than that which was approved in the underlying Cause is more appropriate, we find that no changes should be made to the City's rate structure and the Out-of-Town Differential shall continue to apply. However, because we find the City's cost of service study to be deficient as set forth above and given the fact that the last approved cost of service study supporting the Out-of-Town Differential will have been from more than fifteen (15) years ago, the Commission finds that the City should be prepared to support its proposed rate structure in its next petition for a rate change. Consistent with case law and Commission procedures, any party advocating a change to the City's rate structure in the next rate case should be prepared to prove that its proposed change is appropriate.<sup>5</sup>

**IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION that:**

1. South Bend shall be and hereby is ordered to maintain its existing rate structure as previously approved by this Commission.

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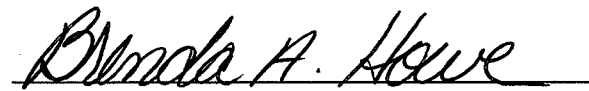
<sup>5</sup>In an effort to provide the parties with additional guidance should they decide to undertake another cost of service study to justify or support a proposed rate structure, we would refer the parties to our guidance set forth in the Evansville Order. As we noted therein, the AWWA Manual sets forth five separate steps necessary to complete a valid cost of service study. Evansville Order at p. 32. These include: selection of cost functions; allocation of cost to cost functions; selection of customer classes; allocation of costs to customer classes; and rate design. In addition, the lengthy well-stated review of the five-step AWWA Cost of Service analysis provided by Intervenor's witness Kerry Heid in that proceeding provides additional guidance. *See* Intervenor's Exhibit KAH-I, filed in *Petition of the City of Evansville*, Cause No. 42176.

2. The investigation initiated in this subdocket shall be and hereby is terminated.
3. The Order shall be effective on and after the date of its approval.

**HARDY, LANDIS, AND ZIEGNER CONCUR; GOLC AND SERVER ABSENT:**

**APPROVED: AUG 13 2008**

**I hereby certify that the above is a true  
and correct copy of the Order as approved.**

A handwritten signature in cursive script, reading "Brenda A. Howe", is written over a horizontal line.

**Brenda A. Howe  
Secretary to the Commission**